No. 11,912

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

THE DAVENPORT FOUNDATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF ON BEHALF OF PETITIONER.

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Comment on Respondent's Statement of Facts.

The general picture presented by the respondent's statement of facts resembles the one which appeared in the petitioner's statement of facts but respondent has omitted certain facts which it is believed should be in mind in determining whether petitioner is exempt from tax.

Respondent did not state that Levi M. Davenport transferred substantially all of his property to La Verne College [Tr. 34], or that he never accepted any of the $400.00 monthly payments provided for by the original trust [Tr. 62, 64], or that petitioner has never paid any amount for the support of the brother or sons of Levi M. Davenport [Tr. 65, 150], or that the brother and children of petitioner were so fixed financially that they would not be likely to ever call upon petitioner for as-

sistance [Tr. 67-71, incl.]. Furthermore, respondent did not state that any payment to the trustor's brother was to be discretionary with the Trustees [Tr. 86].

Petitioner believes that the evidence shows that petitioner took the assets subject to the debts or claims owing to the daughter and son of Levi M. Davenport in the amount of $1,000.00 and $625.00, respectively [Tr. 66-70, incl.].

Petitioner believes that the evidence shows that the annuity agreements of May 31, 1941, created obligations of petitioner which were to be in lieu of obligations set up in the original trust indenture. Reference to the evidence on this point is made at pages 8 and 9 of petitioner's original brief. The respondent suggests that any change in the original obligations would have constituted a partial withdrawal or revocation by Mr. Davenport or perversion of the trust, but it should be noted that this change was not a unilateral action by Mr. Davenport but a bilateral agreement entered into between Mr. Davenport and petitioner in which, presumably, new obligations equal to the old obligations were set up.

Finally, the respondent's figure of $518.68 paid by petitioner to organizations not established as exempt under the Code, is erroneous. See page 7 of respondent's brief. At the beginning of the trial a stipulation was filed, that certain facts were true but that evidence could be introduced at the trial not contradictory thereto. The stipulation stated that the taxpayer had paid $518.68 to organizations for which no known exemption from income

tax had been granted. Then at the trial testimony was introduced which showed that the following contributions were to tax exempt organizations:

Phillips China Relief [Tr. 63, 64, 65]	$150.00
Radio Gospel Hour (Dr. M. H. Fagan) [Tr. 72]	85.00
Flora, Evangelist [Tr. 72]	8.00
Total	$243.00

It was further stipulated that $19,881.09 was contributed to organizations which were known to be exempt from income tax [Tr. 79]. The Tax Court then found that $20,124.09 had been contributed to organizations exempt from income tax. This was made up of the $19,-881.09, stipulated on page 79, and the $243.00 as to which testimony was given at the trial. This then would take the $243.00 out of the $518.68 and reduce it to $275.68. Then out of the $275.68 should come the $50.00 paid to the Property Owners' Association of California as a business expense. Furthermore, that Property Owners' Association was exempt from income tax under provisions of Section 101(8) of the Internal Revenue Code [Tr. 81]. Hence, the contributions made to organizations with no known income tax deductions, aggregated $225.68 rather than $518.68.

REPLY TO RESPONDENT'S ARGUMENT.

I.

Petitioner Is Exempt Under Section 101(6) of the Internal Revenue Code.

The purpose for which petitioner and its predecessor were organized was to give to charity and religious education all of Mr. Davenport's property except bare necessities of life for himself and his wife for life, a small annuity for his daughter, and a possibility of a slight provision for the other members of the grantor's family.

Mr. and Mrs. Davenport had an estate of approximately $270,000.00. The income from this was more than sufficient to provide for their support. His fortune was adequate to provide substantial legacies to his children. If those uses of the property had been his chief concern, he would simply have kept the property and not formed petitioner or its predecessor.

But Mr. Davenport wished to give to charity everything excepting a bare living for himself and wife, with a little protection, for lives in being, of his brother and children. But thereafter everything was to belong to the charitable organization. The amounts reserved by Mr. Davenport for himself and family were less than the income of the trust, leaving to the charitable trust and the corporation, the entire corpus and some of the income for the first few years, and all of the income after lives in being.

The entire record leaves no doubt but that the above represent the purpose for which the trust and the corporation was formed. The dominant purpose of petitioner and its predecessor was to extend religious education. The grantor transferred the trust property to a denomination-

al college and appointed as trustees the president of the college, two ministers, a daughter of the trustor, and one other person. The trust indenture provided that a department of philosophy and religion would be established and would be supported out of the trust income. It also provided for an annual payment to the American Bible Society. Then, after making provision for the support of the trustor and wife for life, with discretionary power to give assistance in case of want to his brother and children, he provided that the rest of the income should be distributed as determined by the Board of Trustees for the purposes consistent with the purposes of the trust. The type of religious education to be taught is fully set out in the trust indenture. The indenture provided that all of the successor trustees of the trust had to be approved by the Elders' Body of the Church of the Brethren of the District of Southern California and Arizona, and each such person so approved had to be a person who, by his life and conduct, could subscribe to a very strict code of moral ethics and that such a trustee might be removed if he became unfit to serve by becoming ethically or scriptually embroiled in the evil things of the world. In arranging for the compensation for the trustees the trust instrument stated that it was hoped that all those having to do with the management of the Foundation would have the sacrificial spirit, in order that the work set up by the trust would grow and prosper. The indenture also provided that others might add to the foundation provided additional income should be used in maintaining the doctrines and principles of the Church. It further provided that should La Verne College fail to establish this department of philosophy and religion, and to carry out the teachings as enunciated, or it should be merged or consolidated with any other educational or charitable institution or cease to

exist, then the trustees should pay the income therein provided to be paid to it, to some other institution within the same church denomination, and a new trustee would take the power of La Verne College as title holder. In the by-laws it was provided [Tr. 107] that the Board of Trustees of the Foundation should send an annual report of the business of the Foundation to the District Conference of the Church of the Brethren of the District of Southern California and Arizona not later than 20 days before the annual meeting of said District Conference.

The Articles of Incorporation of petitioner stated that its purpose was to act as trustee under Christian, educational, charitable, eleemosynary and other charitable trusts, and to operate without pecuniary gain or profit to the members. Vacancies on the Board of Directors of petitioner were to be filled by the Elders' Body of the Church of the Brethren, with the same qualifications as were required by the trustees of the predecessor trust. Hence, the trust indenture, the Articles of Incorporation and the history and background of the transaction, show that the trust property was irrevocably devoted to the *kind* of a charity specifically prescribed in the case of La Verne College.

As to the *operations* of the trust and the corporation. all of the income, excepting the amount necessary for the bare maintenance and support of the grantor and his wife and daughter, was either distributed to charitable, religious and educational organizations or invested in additional property. The grantor, Levi M. Davenport, managed the property of petitioner without salary. He even turned over to the petitioner money he received from renting out one of the rooms in the Davenport home [Tr. 78]. Neither the brother nor the sons of Levi M. Daven-

port ever received anything from this trust or petitioner, excepting the $625.00 Homer Davenport received for his interest in the assets transferred to petitioner's predecessor.

Perhaps the best test of the dominant purpose of the petitioner and predecessor is to determine whether the most money or property was available for the charitable or the private use. Attached hereto, as an appendix, is a statement showing the net income from the property transferred by Levi M. Davenport to the petitioner and its predecessor to December 31, 1944; also the amounts which were reserved by or paid over to Mr. Davenport and his wife and daughter, as well as the balance remaining. The record shows that the petitioner and predecessor received property of the value of $270,384.00 [Tr. 76, 78] and the exhibit in the appendix shows that the property produced a net income up to December 31, 1944 of $70,409.87; a grand total of $340,793.87. The same exhibit will show that Mr. Davenport, his wife and daughter received from the beginning of the trust until December 31, 1944, money, or use of property, having an aggregate value of $31,875.00. If there is added in, contrary to petitioner's conviction, the $1,625.00 paid to the daughter and son of Mr. Davenport, for assets transferred to petitioner, the total amount the family received up to December 31, 1944, was $33,500.00. This is less than half the income. The same proportion no doubt prevailed in 1945 and 1946 and until Mr. Davenport's death on January 6, 1947 (Mrs. Davenport died in 1943).

This would leave, as of January 6, 1947, petitioner in possession of the original capital $270,384.00, plus more than half the income from October 8, 1940 to January 6, 1947, and subject only to the following:

1. An annuity to Mr. Davenport's daughter of $100.00 per month which, of course, equals a small portion only of the income of the property. From January 1, 1947, to the end of her expectancy this would hardly exceed $18,400.00 in the aggregate.

2. The possibility, as contended by respondent, that further amounts of income might be paid out to the brother and children of Mr. Davenport. Petitioner believes that these rights have been cut off and further points out that any payments to the brother and children is discretionary with the Board of Trustees. The brother, John R. Davenport, was, on February 28, 1947, 71 years of age. He testified that he had property worth $18,000 or $20,000, net, and received about $200 per month from it, and that he had no dependents or children, and that his property was sufficient to keep him. Ralph M. Davenport, son, on January 1, 1947, was about 51½ years of age, had received $35,000 from his father, had an important position with the gas company, received a very good salary, lived in a large house and did not have a large family. Homer H. Davenport, son, was about 45 years of age on January 1, 1947, was married and had no children. He was worth about $30,000. His property was producing considerable income. He was not otherwise employed and was in poor health. Lucille D. Weller, the daughter, was nearly 54 years of age on January 1, 1947, was married to an able-bodied man and had a married daughter who was not dependent on her. The income of her husband and

herself was more than enough to take care of them. Her husband and herself were worth $85,000 to $100,000.

If Homer Davenport became in need of assistance, and if the Board of Trustees of petitioner decided to help him, such assistance would not exceed a small portion of petitioner's income, and then for a few years only. Thereafter, petitioner would own, free and clear of all encumbrances and liabilities, the assets worth $270,000.00 in 1939, and probably worth a great deal more in 1947. The property was producing a net income of around $18,500 a year in 1944, and it will probably keep up at that rate indefinitely.

Consequently, petitioner has received up to January 6, 1947, net assets and net income, over and above the amount it has paid or will have to pay therefor, of at least $300,000.00.

The figures tell the story. They demonstrate the dominant purpose of the trust and of the creation of petitioner and of the transfer of the property to it. The figures show that the grantor's purpose was to give everything he had to charity, excepting a frugal existence for himself and wife for the few remaining years of their lives and a small annuity to his daughter. In other words, he intended to give all he possibly could, and still sustain life.

Petitioner and its predecessor received property subject to certain conditions, reservations and exceptions. The faithful performance of these conditions was a condition to its obtaining the property—a part of the purchase price of the property. It is not material that these requirements on behalf of the grantor technically amounted to reservations and exceptions. The net effect determines

the point and in the case at bar Mr. Davenport transferred the property to the trust and the corporation in consideration of certain reservations and certain trust income. He reserved those rights and the corporation never received those rights. It only received the balance. In *Kirby Petroleum Co. v. Commissioner* and *Commissioner v. Crawford,* 326 U. S. 599, the Supreme Court held that a lessor who was to get a portion of the net income realized from the operation, by the lessee, of the oil well, retained an economic interest in the property entitling him to depletion deductions, and that the lessee did not own such portion of the operating income. That decision is cogent authority for this proposition that the rights to income retained by Mr. Davenport amounted to reservations or exceptions from the property interests transferred to petitioner.

The Supreme Court case of *Lederer v. Stockton,* 260 U. S. 3, is of course the leading authority on the proposition that property transferred to a charitable organization subject to a reservation, does not deprive the organization of its exemption.

The following cases are authority for the proposition that the exemption is not destroyed because of the fact that the charitable organization pays out portions of *net income* to the nominees of the grantor. *Estate of J. B. Whitehead v. Commr.*, 3 T. C. 40, affirmed 147 F. (2d) 957, and *Edward Orton, Jr. Ceramic Foundation,* 9 T. C. 541.

In the *J. B. Whitehead* case, *supra,* the net estate of the decedent was left to a charitable foundation. The will provided that two annuities aggregating $15,000 per year

would be paid *out of income* for 20 years. The foundation and estate were also to settle contracts with testator's wife and former wife. Exemption was granted despite the fact that some of the income was paid to private persons and this annuity was not a charge on capital but was merely to come out of income.

In the *Edward Orton, Jr. Ceramic Foundation* case, *supra,* there was created by will a foundation to run a cone business for educational purposes. Out of the income of the foundation, testator's wife or issue were to get specific sums each year for five years, totaling $42,000.00. These amounts were not payable in all events or out of corpus, but merely out of the income. Nevertheless, the Tax Court held that the foundation was exempt. There the Tax Court said:

> "The payments of income to the wife, both under the will and under the agreement, were not the real purpose for which the foundation was established. They were a charge upon its entire assets and had to be paid in order to free the assets and income for use in the scientific aims of the foundation. In this respect the facts were indistinguishable from those in *Emerit E. Baker, Inc.,* 40 B. T. A. 555, where we held that a corporation, otherwise entitled to exemptions from income tax under section 101(6) of the Revenue Acts of 1934 and 1936, was not deprived of the exemption because of payment of an annuity to his widow * * *. In the instant case the income-producing property all belongs to the foundation, and if the foundation should cease to exist it will all go to Ohio State College after the death of the life annuitant."

As shown by the above cases, it is immaterial whether a charitable foundation gets property subject to a specific annuity, which is a charge on all income and assets, or merely subject to the payment of certain amounts out of income, or portions of the income. In either case, it has to pay the amounts in order to free the assets from obligations so that they can be devoted to certain charitable purposes.

The real test then, in this type of case, is not whether some of the assets or income must be paid to private persons but whether the dominant purpose is to provide for charitable uses, or to make provision for private persons. In that connection the dominant purpose cannot be determined by the purpose which is first set forth in the trust indenture, as argued by the respondent on page 10 of his brief. In the case of *Emerit E. Baker, Inc.,* 40 B. T. A. 555, Acquiesence 1940-1, C. B. 1, the first purpose stated in the will was a provision for the benefit of the testator's wife. Nevertheless, The Tax Court properly held that this was not the dominant purpose of the trust. It was merely incidental to the dominant purpose of providing for charity. Likewise, in the case at bar the fact that the first provision for the distribution of income was the matter of $400 for the support of the grantor, does not mean that was the dominant purpose of the trust. The Tax Court said in *Edward Orton, Jr. Ceramic Foundation,* 9 T. C. 533, page 541:

> "The basis for distinguishing these cases must be found in the general purpose and history of the trusts or foundations under consideration. Where, as in the instant case, the evidence shows a clear and predominant purpose to aid the charity and where the noncharitable benefits are incidental to that purpose,

> we think that the exemption should be allowed. As stated in *Helvering v. Bliss,* 293 U. S. 144: '* * * The exemption of income devoted to charity and the reduction of the rate of tax on capital gains were liberalizations of the law in the taxpayer's favor, were begotten from motives of public policy, and are not to be narrowly construed * * *.'"

That the dominant motive of the grantor in *Scholarship Endowment Foundation v. Nicholas,* 106 F. (2d) 552, cited by respondent, was to provide for the grantor is shown by the fact that in 1934 when the trust had property worth $34,000 only, the indenture was amended to provide an annuity of $5,000 per year for the life of the grantor and his wife. Previously, he had reserved all the income for the life of the donor, and after his death to his wife during her life. These arrangements showed that the grantor did not intend that the charity should get anything during the life of his wife or himself. Thereafter, and at the beginning of the taxable year 1936, he did contribute an additional $130,000 in property, but out of gross income in 1936 of nearly $16,000, only $1,000 was distributed for scholarships, and $5,000 was available to the grantor and his wife, although he drew only $2,000 during that year. The Court was justified in holding that during the life of the grantor and his wife the dominant purpose of the trust was to pay them all of the income, or even more than the income.

As the District Court said, 25 Fed. Supp. 511, page 514:

> "Under the first contract the donor was to receive the entire income leaving nothing for charitable objects. Then a new agreement was entered into still more favorable to him * * *."

Respondent also cites The Tax Court decision in *James Sprunt Benevolent Trust,* 20 B. T. A. 19, which held that the trust was not exempt from income tax. In that case, in the preamble of the trust instrument, the trustor stated that he had had a yearning for many years to provide for the temporal support of a son or a grandson, or a blood relation, who would be called to the Gospel Ministry of the Southern Presbyterian Church. In stating the purposes of the trust he said:

> "The first and primary purpose of this trust is, as hereinbefore mentioned, to provide any direct male or female descendant of my parents, * * * who is also a member of the Southern Presbyterian Church, who may make application to this Board, with funds for preparation, and partial or full support in the ministry of the Gospel, or in Missionary work at home or abroad under the Southern Prersbyterian Church, * * *. It is my desire that in such case the trustees shall provide the cost of such preparation and subsequent support, on *liberal lines,* and in the event of the death of any beneficiary leaving a dependent family it shall be the duty of the Trustees to make suitable provision at their discretion, * * *."

Later in the trust he also provided that one-fifth of the income would be used for the private relief or assistance of any worthy lineal descendant of Alexander Sprunt and Jane Dalziel Sprunt, regardless of their church affiliation. The trustor in that case did not put in a limit on

the amount that could be spent for the support of his relatives who were studying for the ministry and did provide that 20% of the income was to be used for the support of other relatives. These payments were to begin immediately. He then made some provisions for charitable uses which were to begin after his death. In addition he provided that 10% of the income of the trust would be paid out for the support of underpaid Presbyterian ministers and further provided that the trustees should pay $50,000.00, when convenient, to the Davidson College. These last two items were apparently to begin immediately. The capital contributed to the trust was $500,000.00, par value, of 7% debentures. While the Board of Tax Appeals would have been justified, under the present test, of holding that the trust was not exempt because its dominant purposes were private benefits rather than charitable uses, it actually used a test which ignored the principle established by the Supreme Court in *Lederer v. Stockton,* 260 U. S. 3, that the exemption would not be lost even though some of the income went for private use, if this portion was incidental to the dominant charitable purposes. It will be noted that The Tax Court in the *James Sprunt Benevolent Trust* case did not refer to *Lederer v. Stockton.* The more recent cases, such as the *J. B. Whitehead, Emerit E. Baker* and *Edward Orton, Jr. Ceramic Foundation* cases take into consideration the principle enunciated in *Lederer v. Stockton,* and permit some distribution of income to private persons but allow exemption if the dominant purpose is charitable.

Respondent says on page 13 of his brief that the fact that Mr. Davenport directed where the contributions were to be made, meant that such portion of the income inured to him and this defeated the exemption. But in *Eppa Hunton,* 1 Tax Court 821, the trust indenture provided that the grantor's wife would have the sole right of designating the beneficiaries during her life. The Tax Court there did not consider that this amounted to a distribution for her benefit, and held the trust was exempt from income tax.

Petitioner and its predecessor received $270,000.00 worth of property and are entitled to keep all the income therefrom in consideration for allowing to the grantor and his wife and daughter, and perhaps his brother and sons, some small portion of the company's income for a limited period of time. Thereafter the corporation would have the property and its income free from any obligations, free to advance Christian education and otherwise invest in charitable and educational and religious purposes. It received, taking everything into consideration, a very substantial gift from Mr. Davenport for charitable purposes.

Petitioner has expended all its income, left to it after paying the amounts required to enable it to receive the property, for charitable purposes, except such portions as it accumulated for expanding its property.

The dominant function is a charitable and educational and religious one and, therefore, exemption follows.

II.

Petitioner Is Exempt Under Section 101(14) of the Internal Revenue Code.

As shown in the preceding portion of this brief, petitioner was organized for the dominant purpose of carrying on educational, religious and charitable work and has used all of the funds available to it, after payments required of it by the grantor, for such purposes. Payments have been made only to organizations exempt from income tax, excepting a very small amount which should be ignored under the *de minimis* doctrine. Any unauthorized payments will be recouped by petitioner.

The fact that petitioner accumulated some of its income for the purpose of increasing or improving its properties, hence creating more income for charitable and educational purposes, does not deprive it of exemption. See *William C. Bruckner,* 20 C. T. A. 419.

The respondent, on page 20 of his brief, cites the case of *Banner Building Co. v. Commissioner,* 46 B. T. A. 857. The corporation there involved was a private business corporation organized for profit. Its by-laws provided that the profit would be distributed to the stockholders. It raised capital by selling stock to members of a lodge, erected a building, and rented the building out to the lodge. The facts are so clearly distinguishable that they will not be further considered.

Respondent argues on page 20 of his brief that the trust indenture in the case at bar does not specify what exempt organization is to get the balance of income left over after provisions have been made for the trustor, La Verne College and the American Bible Society, and the brother and children of the trustor. Respondent con-

cluded that there was no intention that the Foundation be organized to get net income into the hands of an exempt organization.

But in *N. P. E. F. Corp. v. Commissioner,* decided April 29, 1946 (1946 Prentice-Hall Tax Court Memorandum Decisions, par. 46,100), the Tax Court allowed exemption under Section 101(14) of the Internal Revenue Code where the taxpayer's *operations* satisfied the test of the statutory requirement that it be "organized" and "operated" for charitable purposes but the charter did not specify that the net income was to be paid to some exempt organization. The Commissioner in that case argued that the N. P. E. F. Corp. was not exempt as it was not "organized" to turn net income over to exempt organizations, even though it actually did so. The Tax Court said:

> "But the statements upon which respondent relies for this proposition contained in *Sun-Herald Corporation* vs. *Duggan* (C. C. A., 2nd Circuit), 73 Fed. (2d) 298 (4 U. S. T. C., par. 1355), certiorari denied, 294 U. S. 719, were repudiated by the same court in *Roche's Beach, Inc.* vs. *Commissioner* (C. C. A. 2nd Circuit), 96 Fed. (2d) 776, (381 U. S. T. C., par. 9302)."

Therefore, petitioner in the case at bar distributed, or accumulated for later distribution, all the income available to it, after making the payments required in order to obtain the property, to exempt organizations. It is exempt under Section 101(14) even though the trust indenture does not specifically set forth the name of the organization to which the excess income is to be paid.

The respondent on pages 21 and 22 of his brief seems to concede that $200 or $300 which petitioner paid to

non-exempt organizations can be ignored under the *de-minimis* doctrine. He suggests however, that the petitioner is claiming that the amounts going to the members of the trustor's family should also be ignored under the *de minimis* rule. Petitioner does not make that claim as it feels that the amounts going to the trustor's family, went by virtue of reservations or exceptions and were payments required to be made by petitioner in order to obtain the property.

Respondent also apparently concedes on page 22 that the recoupment of unauthorized distributions would save petitioner's exemption.

Petitioner, therefore, was organized and operated to turn over all of its own net income to organizations exempt from tax. It is exempt under Section 101(14) of the Internal Revenue Code.

Conclusion.

The decision of the Tax Court is erroneous and should be reversed.

Respectfully submitted,

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August 27, 1948.